

REPORT OF EXAMINATION  
OF THE  
LANDMARK INSURANCE COMPANY  
  
AS OF  
DECEMBER 31, 2005

Participating State  
and Zone:

California

Filed June 29, 2007

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Los Angeles, California  
April 16, 2007

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable Kent Michie  
Secretary, Zone IV-Western  
Commissioner of Insurance  
Department of Insurance, State of Utah  
Salt Lake City, Utah

Honorable Steve Poizner  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

#### LANDMARK INSURANCE COMPANY

(hereinafter also referred to as the Company or Landmark) at the primary location of its books and records, 70 Pine Street, New York, New York 10270. The Company's statutory home office is located at 2730 Gateway Oaks Drive, Suite 100, Sacramento, California 95833.

#### SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination.

The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

The examination of the Company was made concurrently with the examination of the following Delaware domiciled affiliated companies:

Lexington Insurance Company (Lexington)  
Starr Excess Liability Insurance Company, Ltd. (Starr Excess)

### SUMMARY OF SIGNIFICANT FINDINGS

Following receipt of subpoenas from and commencement of investigations by various regulatory agencies, in March 2005, the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of the Company's ultimate parent, American International Group, Inc. (AIG's), retired and resigned, respectively. In connection with the preparation of AIG's consolidated financial statements, AIG's current management initiated an internal review of AIG's books and records, which was substantially expanded in mid-March 2005 with the oversight of the Audit Committee of the Board of Directors.

Based on its evaluation and the identification of the material weaknesses in internal control over financial reporting and new information about pre-existing facts which came to AIG's attention during the course of its internal review, and because of an inability to file AIG's Annual Report on Form 10-K within the statutory time period, AIG's current CEO and CFO concluded that, as of December 31, 2004, AIG's disclosure controls and procedures were ineffective based on the criteria in the report Internal Control – Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission (COSO).

The following are the control deficiencies as of December 31, 2004 that were noted and AIG developed a comprehensive plan to remediate the material weaknesses identified:

- Control environment
- Controls over the evaluation of risk transfer
- Controls over certain balance sheet reconciliations
- Controls over the accounting for certain derivative transactions
- Controls over income tax accounting

As a result of this review together with the results of investigations conducted by outside counsel at the request of AIG's Audit Committee, and in consultation with AIG's independent registered public accounting firm, AIG restated its audited consolidated financial statements for the years ended December 31, 2003, 2002, 2001, and 2000, and its unaudited condensed consolidated financial statements for all its quarterly statements, 2003 and 2004 and the year ending December 31, 2003 (the First Restatement).

On November 9, 2005, AIG announced that it had identified certain additional errors, the preponderance of which were identified during the remediation of the material weaknesses in internal control over financial reporting. Subsequent to this announcement, and in connection with its ongoing remediation efforts, AIG identified certain additional errors principally relating to internal controls over reconciliation of certain balance sheet accounts in the Domestic Brokerage Group (DBG). Due to the significance of these additional errors, AIG restated its consolidated financial statements for the years ended December 31, 2004, 2003 and 2002, along with 2001 and 2000, for purposes of preparation of the Selected Consolidated Financial Data for 2001 and 2000, and quarterly financial information for 2004 and 2003 and the first three quarters of 2005 (the Second Restatement).

As of December 31, 2005, the material weaknesses relating to the control environment (i.e. management changes) and controls over the evaluation of risk transfer (i.e. reclassification of certain reinsurance transactions as deposit accounting) were remediated. However, the material weaknesses relating to: (1) controls over certain balance sheet reconciliations, (2) controls over the accounting for certain derivative transactions, and (3) controls over income tax accounting, remained as they were not fully remediated.

Throughout 2005 and continuing in 2006, AIG has devoted significant efforts towards remediation of the three remaining material weaknesses, and remediation of AIG's control environment has aided in these efforts. AIG management continues to assign the highest priority to AIG's remediation efforts in these areas. Due to the nature of the remediation process and the need to allow adequate time after implementation to evaluate and test the effectiveness of the controls, management has given no assurance as to the timing of complete achievement of remediation. As part of its remediation efforts, AIG management represents its intention to develop new systems and processes, which will allow it to rely on front-end preventative controls, which will be more sustainable over the long term. During the examination, AIG management represented its commitment to making the investments necessary to make these improvements.

AIG has taken specific remediation steps with respect to its three remaining material weaknesses:

- Controls over certain balance sheet reconciliations: AIG has implemented the following measures to enhance its ability to identify, assess, measure and help to ensure the accuracy of its balance sheet accounts:
  - Adoption and implementation of new corporate guidelines on balance sheet reconciliations;
  - Implementation of new programs to train staff on the requirements of the new guidelines;
  - Enhancement of the oversight of the balance sheet reconciliation function by adding qualified staff and engaging outside resources; and
  - Enhancement of processes for evaluating and monitoring financial statement exposures related to balance sheet reconciliations.
- Controls over the accounting for certain derivative transactions: AIG has taken the following actions to remediate this material weakness:
  - Enhancement of systems and implementation of new controls over the accounting for derivatives and related assets and liabilities;

- Implementation of new procedures and controls to ensure technical compliance with the provisions of Financial Accounting Standard (FAS) 133, including specific documentation requirements, prior to application of hedge accounting by AIG subsidiaries, and
  - Establishment of improved oversight, monitoring and supervision of derivative accounting issues in part, through the hiring of additional personnel with expertise in FAS 133.
- Controls over income tax accounting: AIG has taken the following actions to remediate this material weakness:
    - Implementation of new controls over its accounting for income taxes;
    - Enhancement of its oversight over income tax accounting through hiring of additional qualified staff;
    - Engagement of an outside accounting firm to assist in the analysis of its income tax accounting; and
    - Enhancement of processes for evaluating and monitoring financial statement exposure related to income tax accounting.

At December 31, 2006, the material weakness relative to balance sheet reconciliations and derivative accounting were remediated. The material weakness relative to income tax accounting remained unremediated at December 31, 2006. However, it is AIG's goal to remediate this material weakness by year-end 2007.

AIG Management, in its efforts to mitigate any risk of material misstatement of its financial statements for the DBG Property and Casualty (P&C) group of companies established an allowance provision at year end 2005, in accordance with the Financial Accounting Standard No. 5 – Accounting for Contingencies (FAS 5) reserve. The FAS 5 reserve was established for identified and potential exposures within the DBG's operational areas for certain business segments/profit centers since they affect the entire DBG P&C group of companies. The total DBG FAS 5 reserve established at December 31, 2005 was \$1.8 billion. The FAS 5 reserve for the surplus lines pool

companies, of which the Company is a 2% participant was \$92.7 million. The components of the Surplus Line Pool's FAS 5 Allowance Provision at December 31, 2005 were as follows:

Fusion	\$129,778
Financial Accounting	10,327,791
Premium Receivables	10,535,424
Reinsurance	<u>71,724,680</u>
	(*)
Total Surplus Line Pool FAS 5	\$92,717,673 )

(\*) The Company's share of this reserve was \$1,854,353

The reconciliation and remediation effort continues in 2006 and 2007 on DBG entity general ledger accounts.

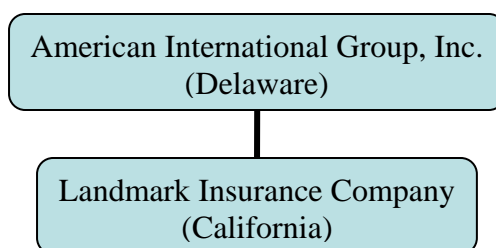
#### SUBSEQUENT EVENTS

The Board of Directors approved a settlement agreement between American International Group, Inc (AIG) and C.V. Starr & Co., Inc. (C.V. Starr). The settlement provided for a global resolution of multiple disputes relating to the termination of the managing general agency relationships between their respective subsidiaries and the use of the "Starr" and "American International" trademarks. As a result of the settlement, AIG will refrain from conducting business under the "Starr" and related names, and C.V. Starr will refrain from conducting business under the "AI", "American International" and related names.



## MANAGEMENT AND CONTROL

The Company is a wholly-owned subsidiary of American International Group, Inc. (AIG). AIG, through its subsidiaries, is primarily engaged in a broad range of insurance and insurance-related activities in the United States and abroad. AIG is a holding company, controlled by its board of directors on behalf of the stockholders. As of December 31, 2005, there were no stockholders that exercise control over AIG. One stockholder, Starr International Company, Inc. held approximately 12% of the shares of AIG, but disclaims any control over AIG. The following abridged organizational chart depicts the Company's relationship within the holding company system:



Management of the Company is vested in a board of directors elected annually. A listing of the member of the board and principal officers serving on December 31, 2005 follows:

### Directors

#### Name and Residence

#### Principal Business Affiliation

Merton B. Aidinoff  
New York, New York

Retired Attorney  
Sullivan & Cromwell

Steven J. Bensinger  
New York, New York

Executive Vice President and  
Chief Financial Officer  
American International Group, Inc.

Charles H. Dangelo  
Manasquan, New Jersey

Vice President and Senior Reinsurance Officer  
American International Group, Inc.

David L. Herzog  
St. Albans, Missouri

Senior Vice President and Comptroller  
American International Group, Inc.

Name and ResidencePrincipal Business Affiliation

Kevin H. Kelley  
Norwell, Massachusetts

Senior Vice President  
American International Group, Inc.

Kristian P. Moor  
Fairfield, Connecticut

Executive Vice President  
American International Group, Inc.

Win J. Neuger  
New York, New York

Executive Vice President and  
Chief Investment Officer  
American International Group, Inc.

Ernest T. Patrikis  
New York, New York

Former Senior Vice President and  
General Counsel  
American International Group, Inc.

Robert S. Schimek  
Newton, Philadelphia

Senior Vice President and  
Chief Financial Officer  
Domestic Brokerage Group  
American International Group, Inc.

Principal OfficersNameTitle

Kevin H. Kelley

Chairman of the Board of Directors and  
Chief Executive Officer

Shaun E. Kelly

President and Chief Operating Officer

Nicolas E. Anselmo

Executive Vice President

Richard H. Bucilla

Executive Vice President

Andrew P. Archambault

Senior Vice President

David J. Bresnahan

Senior Vice President

Elisha E. Camp II

Senior Vice President

Charles H. Dangelo

Senior Vice President

Frank H. Douglas, Jr.

Senior Vice President and Actuary

Peter J. Eastwood

Senior Vice President

Neil A. Faulkner

Senior Vice President

John F. Graham

Senior Vice President

Kenneth V. Harkins

Senior Vice President and  
General Counsel

David A. Jordan

Senior Vice President

Mary E. McCoy

Senior Vice President

NameTitle

Stephen J. Paris	Senior Vice President and Deputy General Counsel
Alan R. Perron	Senior Vice President
Vincent N. Pugliese	Senior Vice President
Charles R. Schader	Senior Vice President
Robert S. Schimek	Senior Vice President and Treasurer
Douglas G. Story	Senior Vice President
George R. Stratts	Senior Vice President
Ervino J. Valle	Senior Vice President
Nicholas C. Walsh	Senior Vice President
John G. Willett	Senior Vice President
Elizabeth M. Tuck	Secretary
Richard T. Pisano	Comptroller

### Intercompany Agreements

**Investment Management Contract:** The Company entered into an agreement with AIG Global Investment Corp. (AIGGIC) wherein AIGGIC acts as an investment manager and advisor for the Company. The agreement provides that investment management fees are to be billed annually at a rate of seventy-five cents (\$0.75) per thousand dollars of assets under management, plus the pro-rated amount of AIG service fees billed to AIGGIC on behalf of the Company. The agreement has been in force since January 1, 1991.

**Joint Asset Agreement:** The Company entered into an agreement with AIG, AIG Capital Corporation, now known as AIGTI, Inc., (Capital Corp.), and certain subsidiary companies of AIG for the purpose of owning, maintaining, investing and reinvesting certain assets. The companies' appointed Capital Corp. as the manager and investment advisor for these jointly owned assets. No assets are currently governed by the agreement, which is in the process of being terminated.

**Tax Allocation Agreement:** The Company is party to a tax allocation agreement with AIG. The agreement sets forth the manner in which the total consolidated federal income tax is allocated to each entity. Generally, this agreement states that AIG agrees not to charge the Company a greater portion of the consolidated tax liability than would have been paid by the Company if it had filed a

separate return. Additionally, AIG agrees to reimburse the Company within 90 days after filing of the consolidated tax return for any tax benefits arising out of the net. The California Department of Insurance (CDI) approved this agreement on November 18, 1998.

Service and Expense Agreement: The Company and other AIG companies receive office and other services from AIG and certain of its subsidiaries under a consolidated agreement and are billed quarterly based on actual costs. The agreement has been in force since 1974.

Surplus Lines Broker Agreement: The Company is party to a Surplus Lines Broker Agreement with its affiliates, Lexington Insurance Company, Starr Excess and New England Risk Specialists, Inc. (Broker), with respect to business placed by Broker with the Company. The commission constitutes full compensation for all services rendered by the Broker. The Company failed to file and seek prior approval from the CDI for this agreement as required by the California Insurance Code (CIC) Section 1215.5(b)(4). As a result, late filing fees will be assessed by CDI. It is recommended that the Company comply with CIC Section 1215.5(b)(4).

Capital Maintenance Agreement: The Company disclosed in its 2006 Annual Statement that it entered into a Capital Maintenance (CM) Agreement with AIG. The agreement provides that in the event the Company's Total Adjusted Capital falls below the Company's Authorized Control Level Risk Based Capital (RBC), which is 200%, together with any adjustments or modifications required by the Company's domiciliary regulator, AIG shall within 30 days of written notice thereof, provide a capital contribution to the Company in an amount equal to the difference between the Company's Total Adjusted Capital and the Company's Authorized Control Level RBC. In lieu of making any capital contributions with the prior approval of the CDI, AIG provided a letter of credit naming the Company as beneficiary.

#### TERRITORY AND PLAN OF OPERATION

The Company writes multi-line property and casualty business on an admitted basis in the following states: Arizona, California, Colorado, Hawaii, Kansas, Massachusetts, Nevada, New York, Oregon,

and Washington. The Company operates on a surplus lines or non-admitted basis in several other states.

Direct written premiums increased from \$1.6 million in 2002 to \$20.7 million in 2005. The Company's writings emphasized moderate to high hazard middle market business by focusing on specialty industries, as well as classes of business that presented opportunities for underwriting profit over the long term, which include non-habitational owners, landlords and tenants (OL&T), manufacturing and various others coverages.

The Company continues to focus on a mixture of profitable non-habitational OL&T, manufacturing, specialty contractors and a variety of professional liability coverages. The Company has reorganized its casualty underwriting staff by product lines, enabling each underwriter to be accountable for and focused on a specific area of expertise. The Company has created Product Line Teams who are responsible for developing complete underwriting guidelines for their respective product lines.

## REINSURANCE

### Intercompany Pooling Agreement

Effective December 31, 1998, the Company entered into a pooling agreement with Lexington Insurance Company (Lexington) and Starr Excess Liability Insurance Company, Ltd. (Starr Excess), whereby the Company cedes 100% of its business to Lexington and Lexington retrocedes 2% of all pooled business to the Company and 18% to Starr Excess, while retaining the remaining 80%. A net settlement is made between each pool member and Lexington of the pool member's cession to Lexington and Lexington's cession to the pool member of gross policy liabilities, gross liabilities for underwriting expenses and reinsurance. Any party may cancel the agreement at any time by giving six months notice. The California Department of Insurance approved this agreement on December 30, 1998.

### Assumed

The majority of the Company's assumptions are through the intercompany pooling agreement with Lexington and Starr Excess. The Company also assumes various lines of business from affiliates and non-affiliates on a treaty and facultative basis. The Company assumes business only where it is not an approved surplus lines writer.

The largest net aggregate amount insured under any one risk (excluding workers' compensation) is limited to \$1,220,800.

### Ceded

The following reinsurance programs are presented on a 100% pooling basis of which the Company's share is 2%.

The Company has property reinsurance which is placed through domestic and foreign reinsurers. The program consists of working and excess layers that cover all property business. In addition, Lexington is a named participant (with certain other AIG insurance subsidiaries and affiliates) under AIG's "external" property catastrophe program. This excess protection covers all AIG property exposures. The summary of this program is highlighted below.

A supplemental coverage for the accident year 2002 was available with loss ratios greater than 88% with National Union Fire Insurance Company of Pittsburgh, PA. (National Union), an affiliate. Further segmentation of the property reinsurance program is provided through specific homeowners lines of business.

### Property

#### Major Working Layers

11.80% AIG Property Quota share limit \$10 million  
Property Per Risk XOL - \$15 million Excess of \$10 million

30% Personal Lines Homeowners Property quota share limit \$5 million  
70% Personal Lines Umbrella quota share limit \$5 million

#### Property Catastrophe Reinsurance

1<sup>st</sup> layer Property Catastrophe - 100% of \$150 million excess \$250 million  
2<sup>nd</sup> layer Property Catastrophe - 100% of \$150 million excess \$400 million  
3<sup>rd</sup> layer Property Catastrophe - 100% of \$150 million excess \$550 million  
4<sup>th</sup> layer Property Catastrophe - 100% of \$200 million excess \$700 million  
5<sup>th</sup> layer Property Catastrophe - 100% of \$250 million excess \$900 million

#### Domestic Personal Lines Property

1<sup>st</sup> layer Catastrophe – 100% of \$35 million excess \$25 million  
2<sup>nd</sup> layer Catastrophe – 100% of \$80 million excess \$60 million  
3<sup>rd</sup> layer Catastrophe – 100% of \$100 million excess \$140 million

#### Starr Excess- Casualty

Starr Excess participates on a 70% quota share treaty with a limit of \$150 million. Additionally, the net is protected by an excess of loss treaty of \$55 million excess of \$50 million.

#### Casualty

Primary Casualty Non-Professional (claims-made basis and claims-incurred basis) - 11% quota share, maximum net \$890,000, maximum ceded \$110,000.

Employment Practices Liability (claims-made basis and claims-incurred basis) - 40% quota share, maximum net \$18,000,000, maximum ceded \$10,000,000.

#### Captives

The Company's captive book of business is primarily composed of Hospital Professional Liability. All policies written are on a claims-made basis. Coverage is essentially primary, and is sometimes written on a self-insured retention, which ranges from \$5,000 to \$1,500,000. Limits of liability are usually \$1,000,000 to \$3,000,000 per claim, with the lowest being \$200,000 and the highest being \$20,000,000. Exposure is always limited by an aggregate limit of liability. Medilink Insurance Company, MPC Insurance, Hamden Assurance, and Onika Insurance Company were the Company's largest captives at December 31, 2005.

## ACCOUNTS AND RECORDS

Schedule F - Reinsurance: Schedule F, Part 3 of the Annual Statement was prepared on a pooled basis, reflecting the Company's pooled percentage of reinsurance transactions with individual reinsurers of the pool. The Company indicated this was the intent of the intercompany pooling agreement, however, the intercompany pooling agreement as written designates Lexington Insurance Company (Lexington) as the lead company of the pool and in charge of all reinsurance for the pool's business.

Some reinsurance agreements showed Lexington as the ceding company for the group. Therefore, the Company's Annual Statement should either indicate reinsurance transactions only with Lexington or include each of the pool participants on each reinsurance agreement. The Company filed an amendment to its intercompany pooling agreement with the California Department of Insurance (CDI) as required by California Insurance Code (CIC) Section 1215.5(b)(4). The purpose of the amendment was to clarify that all outside reinsurance would apply to the pooling participants in proportion to their respective pooling percentages. A review made by the CDI noted there were discrepancies in the proposed language. The Company met with the CDI staff on March 6, 2007, and it was recommended that the Company re-file an amended agreement with the proposed language suggested during the meeting to comply with CIC Section 1215.5(b)(4).

Schedule T – Premiums Written: A review of the Company's Schedule T direct written premium data disclosed numerous errors relative to the coding of business to the various states for years up to and including 2005. Various Domestic Brokerage Group (DBG) Profit Centers were erroneously writing business on inappropriate/unlicensed legal entity paper. Consequently, some of the DBG companies have issued a considerable number of policies in jurisdictions where they were not licensed. As a result, direct written premiums for approximately twenty-five (25) jurisdictions including Canada and U.S. Virgin Island were misstated.

The effect of the miscoded policies could mean an over payment of premium taxes to some jurisdictions and an under payment of premium taxes to other jurisdictions (either by the companies, for authorized business or by brokers, for surplus lines business). During the course of examination,



it was recommended that the Company implement controls to ensure proper coding of direct written premiums to the appropriate insured state or territory.

In mid-2006, AIG began to implement controls to address the underwriting compliance issue described above. AIG Management anticipates that by mid-March 2007, programming controls will be implemented, which will only allow policies to be written in a particular state on appropriate/admitted legal entity paper. The new underwriting controls will apply to new and renewing policies.

Intercompany Transactions: A review of the intercompany transactions was performed in conjunction with the review of the receivables and payables from/to parents, subsidiaries and affiliates. The Company is not settling its intercompany balances in accordance with the terms of Article IV of the Inter-Company Pooling Agreement nor with paragraph 5 of the Service and Expense Agreement. It is recommended that the Company comply with its settlement terms of the Inter-Company Pooling and Service and Expense Agreements.

Unclaimed Property: A review of the Company's escheat process was performed in conjunction with the review of the drafts outstanding liability account. Based on the outstanding check listings provided by the Company there were outstanding checks from 1996 to 2005.

The Company has a written procedure in place for handling outstanding loss checks in excess of \$50. However, the Company could not provide procedures for the handling of outstanding loss checks \$50 and under and these checks are not being tracked. A review of escheat reports for the year 2005 indicated that the reports appeared to be inaccurate. There were checks which were issued by the Company that were significantly aged (1996-2002), but had not yet been escheated to the states. Moreover, outstanding checks \$50 and under have not been escheated to any state. It is recommended that the Company develop written procedures to track outstanding checks \$50 and under and include these checks in the Unclaimed Property reports. It is further recommended that the Company comply with the California Code of Civil Procedure, Title 10, Chapter 7, regarding the Unclaimed Property Law.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2002, through December 31, 2005

Reconciliation of Examination Changes as of December 31, 2005

Statement of Financial Condition  
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 217,449,832		\$217,449,832	
Stocks: Common stocks	18,253		18,253	
Cash and short-term investments	10,765,296		10,765,296	(1)
Investment income due and accrued	3,226,178		3,226,178	
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	8,553,977	\$ 1,124,793	7,429,184	(2)
Deferred premiums, agents' balances and installments booked but deferred and not yet due	597,125		597,125	
Reinsurance:				
Amounts recoverable from reinsurers	9,531,679		9,531,679	
Funds held by or deposited with reinsured companies	946		946	
Net deferred tax asset	11,241,142	4,860,438	6,380,704	
Guaranty funds receivable or on deposit	3		3	
Electronic data processing equipment and software	6,862	6,862	0	
Receivable from parent, subsidiaries and affiliates	45,087,153		45,087,153	(3)
Aggregate write-ins for other than invested assets	(1,341,974)	1,376,749	(2,718,723)	(4)
Total assets	<u>\$ 305,136,472</u>	<u>\$ 7,368,842</u>	<u>\$297,767,630</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$120,844,245	(5)
Loss adjustment expenses			15,714,616	(5)
Commissions payable			(70,379)	
Taxes, licenses and fees			44,346	
Current federal and foreign income taxes			2,925,883	
Unearned premiums			48,856,431	
Ceded reinsurance premiums payable			9,366,262	
Funds held by company under reinsurance treaties			489,835	
Provision for reinsurance			3,282,869	(6)
Drafts outstanding			67,897	(1,7)
Payable to parent, subsidiaries and affiliates			210,848	(3)
Payable for securities			171,544	
Aggregate write-ins for liabilities			<u>263,385</u>	(8)
Total liabilities			202,167,782	
Aggregate write-ins for special surplus funds		\$ 76,378		
Common capital stock		4,100,000		
Gross paid-in and contributed surplus		4,400,000		
Unassigned funds (surplus)		<u>87,023,470</u>		
Surplus as regards policyholders			<u>95,599,848</u>	
Total liabilities, surplus and other funds			<u>\$297,767,630</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$ 79,992,035
Deductions:		
Losses incurred	\$ 57,907,292	
Loss expenses incurred	8,267,486	
Other underwriting expenses incurred	12,085,230	
Aggregate write-ins for underwriting deductions	<u>(801,764)</u>	
Total underwriting deductions		<u>77,458,244</u>
Net underwriting gain		2,533,791

Investment Income

Net investment income earned	\$ 9,524,190	
Net realized capital gains	<u>327,603</u>	
Net investment gain		9,851,793

Other Income

Net loss from agents' or premium balances charged off	\$ (119,804)	
Aggregate write-ins for miscellaneous income	<u>40,044</u>	
Total other income		<u>(79,760)</u>
Net income after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes		12,305,824
Federal and foreign income taxes incurred		<u>3,695,632</u>
Net income		<u>\$ 8,610,192</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 87,843,548
Net income	\$ 8,610,192	
Change in net unrealized capital losses	(513,594)	
Change in net deferred income tax	1,519,473	
Change in non-admitted assets	(198,585)	
Change in provision for reinsurance	673,718	
Aggregate write-ins for losses in surplus	<u>(2,334,904)</u>	
Change in surplus as regards policyholders for the year		<u>7,756,300</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 95,599,848</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2002 through December 31, 2005

Surplus as regards policyholders, December 31, 2002, per Examination	\$77,629,968
-------------------------------------------------------------------------	--------------

	Gain in Surplus	Loss in Surplus
Net income	\$ 19,290,307	\$
Change in net unrealized capital loss		499,247
Change in net deferred income tax	5,625,389	
Change in non-admitted assets		4,013,759
Change in provision for reinsurance	727,691	
Aggregate write-ins for losses in surplus	727,691	3,160,501
Totals	\$ 25,643,387	\$ 7,673,507

Net increase in surplus as regards policyholders	<u>17,969,880</u>
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Surplus as regards policyholders, December 31, 2005, per Examination	<u>\$95,599,848</u>
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Reconciliation of Examination Changes  
as of December 31, 2005

	Per Company	Per Examination	Surplus Increase (Decrease)	Notes
<u>Assets</u>				
Premiums and considerations:				
Uncollected premiums and agents' balances in course of collection	8,295,466	7,429,184	(\$866,282)	(2)
Aggregate write-ins for other than invested assets	(1,361,365)	(2,718,723)	(1,357,358)	(2,4)
<u>Liabilities</u>				
Provision for reinsurance	1,957,272	3,282,869	(1,325,597)	(6)
Aggregate write-ins for liabilities	1,065,149	263,385	<u>801,764</u>	(8)
Net decrease to surplus as regards to policyholders			(\$2,747,473)	
Surplus as regards policyholders, December 31, 2005, per Company			<u>98,347,321</u>	
Surplus as regards policyholders, December 31, 2005, per Examination			<u>\$ 95,599,848</u>	

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Cash and Short-Term Investments

The Company has invested in AIG Money Market Fund which is an affiliated investment and managed by AIG Global Investment Corp, a wholly-owned subsidiary of American International Group, Inc. (AIG). The amount of the Company's investment totaled \$9.9 million, which exceeds the limit as prescribed in California Insurance Code (CIC) Section 1215.5(b)(1)(A). It is recommended that the Company file the investment transaction with the California Department of Insurance (CDI) for approval to comply with CIC Section 1215.5(b)(1)(A).

A review of the Outstanding Loss Drafts (OLD) account disclosed that the OLD general ledger account has not been reconciled over the years. The Company has not issued drafts for many years. The checks that were issued were treated like drafts, wherein the cash would remain unchanged until the checks were submitted to the bank by the payee. The OLD account contains transactions related and unrelated to outstanding checks, which remain unreconciled over a number of years. It is recommended that the Company continue to remediate its internal controls related to its balance sheet reconciliation.

### (2) Uncollected Premiums and Agents' Balances in Course of Collection

The examination adjustment in the amount of \$866,282 is comprised of the following items:

- Cash Loss Advance (CLA) transactions which is a non-premium related transaction should not be included in this account. The CLA balance was part of the reclassification described in Note (4) Aggregate Write-Ins for Other than Invested Assets. It is recommended that the Company comply with the National Association of Insurance Commissioners (NAIC) Quarterly and Annual Statements Instructions for reporting amounts unrelated to premiums.
- Premiums or Agents' balances, a premium related transaction. The Company failed to properly age its agents' balances and was not able to properly account for the over 90-days

for the uncollected premiums. It is recommended that the Company comply with Statements of Statutory Accounting Principles (SSAP) No. 6, paragraph 9a.

Additionally, the Company netted debits and credits between agents and between unrelated parties which is not in compliance with SSAP No. 6, paragraph 9c. It is recommended that the Company comply with SSAP No. 6, paragraph 9c.

(3) Receivable from Parent, Subsidiaries and Affiliates  
Payable to Parent, Subsidiaries and Affiliates

Upon completion of the control testing performed, the following were noted:

- The Company is a party to the Service and Expense Agreement under which it receives office and other services from AIG and other affiliates. The Company paid cash to American International (AI) Facilities for future furniture, rent and other office expenses that will be incurred by the Company. The Company established a corresponding intercompany receivable for this future expense. The intercompany receivable associated with these types of prepaid expenses is not in compliance with SSAP No. 4, paragraph 3 and should be non-admitted in accordance with SSAP No. 20 and 29, paragraph 2. The amount involved is immaterial therefore no adjustment is recommended. However, it is recommended that the Company comply with SSAP Nos. 4, paragraph 3, and SSAP Nos. 20 and 29, paragraph 2.
- The Company reported a receivable from PSC, Inc., a wholly-owned subsidiary of the Company, for management expenses incurred. There was no formal agreement in place between the parties. It is recommended that the Company formalize this agreement and submit the agreement to CDI to comply with CIC Section 1215.5(b)(4).

(4) Aggregate Write-Ins for Other than Invested Assets

The examination adjustment in the amount of \$1,357,358 is comprised of the following items:

- A reclassification of a cash loss advance, as described in Note (2) “Uncollected Premiums and Agents’ Balances and In Course of Collection” which is a non-premium related transaction.



- Allowance Provision: AIG Management, in its efforts to mitigate any risk of material misstatement of its financial statements for the Domestic Brokerage Group (DBG) Property and Casualty (P&C) group of companies established an allowance provision at year end 2005, in accordance with the Financial Accounting Standard No. 5 – Accounting for Contingencies (FAS 5) reserve. The FAS 5 reserve was established for identified and potential exposures within the DBG’s operational areas for certain business segments/profit centers since it affect the entire DBG P&C group of companies. As the reconciliation and remediation effort continues on the DBG entity general ledger accounts, the Allowance Provision (FAS 5 reserve) was found to be deficient on the following areas:
  - Fusion: A reserve increase was established due to the surplus lines tax case in the Texas Supreme Court wherein the Company lost the case *Strayhorn v. Lexington Insurance Company*. The increase was a result of the 1996-2006 estimated expense on a settlement with Texas.
  - Premium Collection: A reserve increase was noted between the 4<sup>th</sup> quarter of 2005 and 4<sup>th</sup> quarter of 2006. The FAS 5 Reserve for year-end 2005 was fully used to reduce the over 90-day penalty in Uncollected Premium. The reserve increase stemmed from the following: (1) PeopleSoft Ledger Validation (reconciliation of general ledger accounts), (2) ART Subledger Validation (debit receivables, credit suspense, run-offs), (3) PeopleSoft Subledger Validation (potential charge-offs of future receivables), (4) Guaranteed Cost (Legal) (non loss sensitive business legal collections, and (5) RSO Provision (taxes paid to states but not yet collected from brokers/insureds).
  - Reinsurance: A reserve increase was made based on the Summary of Aggregated Deficiencies (SAD) noted by the Company’s Certified Public Accountant (CPA) as a result of the inadequate accounting controls related to the processing and recording of reinsurance transactions at December 31, 2005.
  - Financial Accounting: One area on this adjustment is related to the Company’s exposure on the Outstanding Loss Drafts (OLD). OLD is an account that reflects issued checks that have not been cleared by the bank. In addition to outstanding checks, the OLD account has also been used as a “clearing account” by various

departments without clearly defined ownership/accountability of balances. Some of the transactional activities with OLD include: deductibles, deductible buybacks, salvage, loss clearing, reinsurance and intercompany. There were numerous transactions which remain unreconciled for a number of years.

(5) Loss and Loss Adjustment Expense

The reserves for losses and loss adjustment expenses were analyzed on a pooled basis by a consulting actuary with the firm INS Regulatory Insurance Services, Inc. (INS/RIS, Inc.). The gross and net reserves for losses and loss adjustment expenses were determined to be reasonably stated by the INS/IRIS, Inc. consulting actuary. A casualty actuary from the California Department of Insurance reviewed the actuarial report of the INS/IRIS, Inc. consulting actuary and concurred with the findings.

(6) Provision for Reinsurance

The above captioned account was increased in the amount of \$1,325,597. The review of Schedule F disclosed that some of the reinsurers were categorized as authorized were actuary unauthorized in California. It is recommended that the Company categorize the authorized and unauthorized reinsurers in accordance with the listing of authorized/accredited reinsurers in California and in accordance with the NAIC Annual Statements Instructions for completing Schedule F.

(7) Drafts Outstanding

The Company has not issued drafts for many years. The Company has consistently utilized the “Drafts Issued Method” when reporting issued and outstanding checks. The manner in which the Company has been reporting outstanding checks is not in compliance with the NAIC Quarterly and Annual Statements Instructions and SSAP No. 2, paragraph 7. It is recommended that the Company comply with NAIC Quarterly and Annual Statements Instructions and SSAP No.2, paragraph 7.

(8) Aggregate Write-Ins for Liabilities

The above captioned account was decreased in the amount of \$801,764. The adjustment is a result of the reconciliation and remediation process that was implemented by AIG Management.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Intercompany Agreements – Surplus Lines Broker Agreement (Page 10): The Company failed to file and seek prior approval from the California Department of Insurance (CDI) for this agreement as required by the California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company comply with CIC Section 1215.5(b)(4).

Accounts and Records – Schedule F – Reinsurance (Page 14): It was recommended that the Company re-file an amended intercompany pooling agreement with corrected language.

Accounts and Records – Intercompany Transactions (Page 15): It is recommended that the Company comply with the settlement terms of the Inter-Company Pooling and Service and Expense Agreements.

Accounts and Records – Unclaimed Property (Page 15): It is recommended that the Company develop written procedures to track outstanding checks \$50 and under and include these checks in its Unclaimed Property reports. It is further recommended that the Company comply with the California Code of Civil Procedure, Title 10, Chapter 7, regarding the Unclaimed Property Law.

Comments on Financial Statement Items – Cash and Short-Term Investments (Page 21): It is recommended that the Company file the AIG Money Market Fund investment with the CDI for approval to comply with CIC Section 1215.5(b)(1)(A).

Comments on Financial Statement Items – Cash and Short-Term Investments (Page 21): It is recommended that the Company continue to remediate its internal controls related to its balance sheet reconciliation; one area is the Outstanding Loss Drafts (OLD) account.

Comments on Financial Statement Items – Uncollected Premiums and Agents' Balances in Course of Collection (Page 21): A non-premium related transaction was reported in this account. It is recommended that the Company comply with the National Association of Insurance Commissioners (NAIC) Quarterly and Annual Statements Instructions for reporting amounts unrelated to premiums.

Comments on Financial Statement Items – Uncollected Premiums and Agents' Balances in Course of Collection (Page 22): The Company failed to properly age its agents' balances and was not able to properly account for the over 90-day uncollected premiums. It is recommended that the Company comply with Statements of Statutory Accounting Principles (SSAP) No. 6, paragraph 9a.

Comments on Financial Statement Items – Uncollected Premiums and Agents' Balances in Course of Collection (Page 22): The Company netted debits and credits between agents and between unrelated parties which is not in compliance with SSAP No. 6, paragraph 9c. It is recommended that the Company comply with SSAP No. 6, paragraph 9c.

Comments on Financial Statement Items – Receivable from Parent, Subsidiaries and Affiliates and Payable to Parent, Subsidiaries and Affiliates (Page 22): The Company established an intercompany receivable for prepaid expenses paid to its affiliate for future expenses that will be incurred. It is recommended that the Company comply with SSAP No. 4, paragraph 3, and SSAP Nos. 20 and 29, paragraph 2.

Comments on Financial Statement Items – Receivable from Parent, Subsidiaries and Affiliates and Payable to Parent, Subsidiaries and Affiliates (Page 22): The Company reported a receivable from PSC, Inc., a wholly-owned subsidiary of the Company for management expenses incurred. There was no formal agreement in place between the parties. It is recommended that the Company formalize this agreement and submit the agreement to CDI to comply with CIC Section 1215.5(b)(4).

Comments on Financial Statement Items – Provision for Reinsurance (Page 24): It is recommended that the Company categorize the authorized and unauthorized reinsurers in accordance with the listing of authorized/accredited reinsurers in California and in accordance with the NAIC Annual Statements Instructions for completing Schedule F.

Comments on Financial Statement Items – Drafts Outstanding (Page 24): It is recommended that the Company comply with the NAIC Quarterly and Annual Statement Instructions and SSAP No.2, paragraph 7 for the reporting of outstanding checks.

#### Previous Report of Examination

Reinsurance Captives (Page 10): It was recommended that the Company ensure prompt and timely settlement pursuant to the terms of its treaties with National Union Fire Insurance Company of Pittsburg, PA. The Supplemental and Aggregate Stop Loss treaties with National Union Fire Insurance Company of Pittsburg, PA were not renewed and the balances were settled in April 2004.

Accounts and Records (Page 11): Some reinsurance agreements showed Lexington as the ceding company for the group. Therefore, the Company's Annual Statement should either indicate reinsurance transactions only with Lexington or include each of the pool participants on each reinsurance agreement. The Company indicated that the reinsurance agreements would be revised, prospectively, to indicate each of the pool participations on each reinsurance agreement. The Company has not complied with this recommendation.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

\_\_\_\_\_/S/\_\_\_\_\_  
Grace F. Asuncion, CFE  
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